EXECUTIVE COMPENSATION:

A Primer for Establishing Reasonable Compensation

Prepared for the American Hospital Association and American College of Healthcare Executives by Hogan & Hartson, L.L.P.

Introduction

Executive compensation practices at non-profit organizations recently have come under increased scrutiny from legislators, regulators, the media and even the general public. This scrutiny has taken the form of congressional hearings, investigative reports and increased Internal Revenue Service (IRS) monitoring. It sometimes has resulted in litigation and has spawned new IRS reporting requirements for executive compensation beginning in tax year 2008.

As a hospital leader, it is imperative that you be prepared to provide the leadership necessary to assure policymakers, your Board and the community you serve that the compensation practices at your organization meet the highest standards established by the IRS for tax-exempt organizations. The IRS has published final regulations for determining whether compensation can be presumed to be fair and reasonable. All hospital leaders of tax-exempt institutions should follow these IRS procedures.

This document describes in some detail the pressures recently brought to bear on executive compensation practices, including congressional hearings and reports and new IRS reporting requirements. It then provides a comprehensive overview of the fiduciary duties of the Board and officers of tax-exempt hospitals and the IRS' procedures for establishing that executive compensation practices result in fair and reasonable compensation.

Corresponding documents available at www.aha.org and www.ache.org/ceoresources.cfm provide additional information that may be useful to you as you review your organization's compensation practices.

- "Excess Benefit and Reasonable Compensation: An Analysis of the Intermediate Sanctions Rules" provides a detailed legal analysis of the IRS' intermediate sanctions rules that are the most definitive IRS' guidance on executive compensation. This document will be particularly useful for your legal and compliance staffs.
- "Compensation Compliance Checklist: What Steps Should a CEO Take to Assure Compliance with Legal Standards and Reporting Obligations?" lays out the steps that every CEO should take to assure compliance with IRS standards and reporting obligations around executive compensation.
- The final resource, "Sample Compensation Committee Charter," provides a sample charter your Board can use to establish a specific body to discharge the Board's responsibilities relating to compensation of the executive officers.

Recent Events in Non-profit Executive Compensation

Congressional Activities

Sen. Charles E. Grassley (R-IA), ranking member of the Senate Finance Committee, among others, has expressed a keen interest in executive compensation at tax-exempt organizations. In 2005, Sen. Grassley sent a questionnaire to 10 of the nation's largest non-profit hospitals seeking information on their charitable activities, patient billing practices, ventures with for-profit companies and executive compensation practices. The questionnaire requested a detailed breakdown of the travel expenses of each hospital's five highest-paid employees, and all salaries and other benefits provided to these individuals over the previous three years, as well as reimbursements made to employees for country club membership dues.

In 2006, the Government Accountability Office (GAO) issued a report titled "Nonprofit Hospital Systems: Survey on Executive Compensation Policies." As a result of this report, Sen. Grassley determined that hospital Boards of Directors are not aware of their roles regarding executive compensation and that the IRS should perform more "critical audits" of compensation practices, including the provision of certain fringe benefits. Sen. Grassley also highlighted the "widespread practice" of hospitals providing supplemental executive retirement plans and other deferred compensation to their CEOs and other top executives. Finally, as a result of the report, Sen. Grassley recommended reforms to the requirements for a rebuttable presumption in connection with determining reasonable compensation for officers and directors.

In 2007, in response to an IRS report on nonprofit organizations' executive compensation practices (from a survey of 50 public charities), Sen. Grassley stated that tax-exempt organizations are failing to file the required IRS schedules detailing compensation paid to officers and employees. According to Sen. Grassley, the IRS chief counsel has promised to revisit guidance and regulations regarding executive compensation after the IRS completes its study. The IRS recently announced that its Exempt Organizations Compliance Unit would send compliance questionnaires to about 400 colleges and universities and will examine executive compensation practices, among other issues.

Executive compensation has been, and continues to be, a high-priority item for congressional oversight.

IRS Initiatives

The IRS also has undertaken a number of initiatives aimed at examining executive compensation practices at non-profit organizations.

Hospital Compliance Checklist

In 2005, the IRS sent a compliance checklist to hundreds of tax-exempt hospitals to help determine how much "community benefit" tax-exempt hospitals provide in return for their exemption from federal income taxation. The compliance checklist included a number of questions regarding a hospital's compensation practices.

Form 990

In December 2007, the IRS released a completely redesigned "Form 990, Return of Organization Exempt from Income Tax," which consists of a core form and 16 related schedules. Final instructions for Form 990 were released in August 2008. Non-profit hospitals and other tax-exempt organizations are required to begin using the Form 990 (and most of the schedules) for the 2008 tax year.

The new Form 990 includes extensive additional reporting on executive compensation paid by exempt organizations. As required in previous years, organizations must list their officers, directors, trustees, key employees and the five highest-compensated individuals, and report compensation paid by the organization and any related organizations. They now also must report any compensation from unrelated organizations for services rendered to the filing organization. In addition, the new Form 990 requires reporting of detailed information regarding compensation for these people and the organization's compensation practices.

For example, the new Form requires an organization to report (and describe) whether it provided any of the following for people whose compensation must be reported on Form 990:

- First-class or charter travel.
- Travel for companions.

- Housing allowance or residence for personal use.
- Payments for business use of personal residence.
- Tax indemnification and gross-up payments.
- Health or social club dues or initiation fees.
- Discretionary spending accounts.
- The provision of personal services (e.g., maid, chauffeur, chef).
- Severance or change in control payments.
- Supplemental non-qualified retirement plans and equity-based compensation arrangements.
- Compensation contingent on revenues, net earnings or other non-fixed payments of the organization or any related organization.

The new Form 990 also asks whether an organization's process for determining the compensation of top management officials, officers and key employees includes review and approval by independent directors, review of compensation comparability data, and written records of deliberation and the compensation approved.

Executive Compensation Compliance Initiative

In 2004, the IRS launched an enforcement effort to identify and halt abuses by tax-exempt organizations that pay excessive compensation and benefits to their officers and other insiders. The Executive Compensation Compliance Initiative involved compliance checks of approximately 2,000 non-profit organizations. In March 2007, the IRS released a final report on its findings from the first two parts of the initiative. A report on the last part is forthcoming.

The compliance checks found significant reporting errors and omissions by non-profit organizations. While the project did not uncover widespread excess benefit transactions or instances of self-dealing, the IRS assessed $21 million of excise taxes in connection with the checks. As a result, the project report recommended that a compensation component be included in future compliance initiatives. It also recommended revisions to Form 990 to facilitate accurate and complete reporting of compensation.

Government Accountability Office Report

In 2006, the GAO released a report summarizing its findings from a survey of executive compensation policies and practices at 65 nonprofit hospital systems. The survey and report were part of Congress' "continuing efforts to oversee the activities of the nonprofit sector." The study's key questions involved the type of corporate governance structure in place for executive compensation, the basis for executive compensation and benefits, and the internal controls on approval, payment and monitoring of executive travel and entertainment expenses, gifts and other perquisites.

The responses showed many similarities in the policies and procedures in place at the various hospital systems, with more variation of policies regarding travel and entertainment expenses. The report did not draw any conclusions with respect to the adequacy or sufficiency of any policy, or whether any hospital system was complying with applicable laws.

Independent Sector Organization – Panel on the Non-Profit Sector

In 2005, the Independent Sector Organization convened the Panel on the Non-Profit Sector. Its report incorporated input from thousands of individuals from the charitable community and proposed various actions by charitable organizations, Congress and the IRS. The report recommended imposing penalties on

Board members who "should have known" that an amount of executive compensation was unreasonable (currently, penalties are only imposed on Board members who knew the compensation was unreasonable), and increasing penalties for parties who approve or receive unreasonable compensation. The report also recommended requiring non-profit organizations to disclose in greater detail on Form 990 all compensation received by officers and highly compensated employees. Finally, the report recommended that non-profit organizations revise and strengthen various policies with respect to corporate governance.

Litigation

People v. Grasso

From June through July 2008, the New York courts dismissed six claims brought by the New York Attorney General against Richard A. Grasso, former CEO of the New York Stock Exchange (NYSE). The Attorney General argued that the payment of $139.5 million to Mr. Grasso for the years 2000-2002 was unreasonable under New York's not-for-profit corporation law. This compensation rivaled the NYSE's net income over the same period. The claims were dismissed after the court of appeals held that the Attorney General did not have standing to sue under New York law. The court did not touch on the issue of whether the compensation was reasonable; however, its short ruling suggested that the size of the compensation package alone was not sufficient basis for its reduction, even if it seemed unreasonable on its face. Some commentators have argued that People v. Grasso exemplifies courts' reluctance to get involved in determining what is reasonable compensation.

Maryland CareFirst BlueCross BlueShield CEO Compensation

In July 2008, the Maryland insurance commissioner cut in half the $18 million severance package paid to former CareFirst BlueCross BlueShield CEO William L. Jews. The commissioner held that the compensation package violated a 2003 Maryland law that limits compensation at CareFirst to "fair and reasonable" pay. The law regulating Jews' pay was passed after he unsuccessfully attempted to privatize the company in 2003. The move was blocked on the grounds that it would illegally enrich top executives. Jews' original $18 million severance represented nearly seven times his total compensation in 2006, which the insurance commissioner stated was "simply too much money to pay to the departing CEO of a nonprofit company."

Fiduciary Duties of Board of Directors and Officers of Hospitals

A corporation is governed by the laws of its state of incorporation. State corporate principles generally include a duty of care and a duty of loyalty, each of which is described below. In addition, a duty of obedience has been recognized in recent years. These duties apply both to directors and officers, requiring that officers provide adequate information to the Board in order to aid the directors in their fiduciary duties. An officer or director who is found to have violated his or her fiduciary duties may be held personally liable to the organization for any losses that resulted from the violation.

This section illustrates the fiduciary duties of directors and officers.

Duty of Care

The duty of care generally requires that an officer or director act in a reasonable, informed manner when making Board decisions and overseeing the corporation's management. The duty requires an officer to be informed and discharge his or her duties in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances.

The phrase "like position," as used by the IRS, refers to what a theoretical person with the same characteristics, e.g., background and experience, would have done in the same position. The phrase "under similar circumstances" means that an officer who has specialized expertise would be held to a higher standard than one who does not. Each officer and director shares equally in the responsibility of the Board to act in the best interests of the organization. An officer or director may not vote solely on the basis of what another thinks, even if that other person has special expertise; each director or officer must use his or her independent judgment to evaluate any position taken by another person.

Directors and officers must undertake reasonable inquiry to learn what they need to know to make an informed decision. Further, directors and officers should see that there are procedures in place to ensure that adequate information is available to the Board. An officer or director may rely on information and reports received from Board committees, officers, employees and outside advisors or experts that he or she reasonably believes to be reliable and competent, but cannot blindly rely on financial, legal and other advisors.

When a director or officer acts in a manner that is consistent with his or her duties of care and loyalty, decisions generally are presumed to be valid under the business judgment rule. The courts have developed this presumption partly as a result of their reluctance to "second guess" the ordinary business decisions of directors and officers. Generally speaking, such persons are not liable for actions or decisions that are later proven to be unwise or unsuccessful if they were made:

- in good faith and without a conflict of interest;
- on a reasonably informed basis; and
- with a rational belief that the action or decision is in the best interests of the corporation.

However, some commentators have suggested that it is unclear to what extent the business judgment rule applies to non-profit organizations[1] and that there should be "more rigorous judicial scrutiny" of transactions in which directors may have potential conflicts of interest.[2]

Duty of Loyalty

The duty of loyalty generally requires that directors and officers exercise their powers in good faith and in the best interests of the organization, rather than in their own interests or for the benefit of another person. Breaches of the duty of loyalty typically involve fraud, self-dealing, misappropriation of corporate opportunities, improper diversions of corporate assets and similar matters.

Conflicts of interest involving directors or officers are not inherently illegal. The duty of loyalty focuses on the manner in which the parties consider and determine the propriety of the transaction. One area of concern for non-profit corporations is a director or officer's role in the review or approval of any transaction or arrangement that may appear to benefit one non-profit corporation with which that director is affiliated over another non-profit corporation with which that director also is affiliated. While the director may not stand to receive personal gain, the director may be subject to a claim that the director did not act in the best interests of one of the organizations.

Furthermore, a duty of confidentiality requires that directors and officers keep confidential all matters relating to the non-profit organization until publicly disclosed in a proper fashion.

Duty of Obedience

As noted above, the duty of obedience has been recognized for non-profit organizations in recent years, though the duty rarely has been enforced. The duty generally requires that the director or officer is faithful to the organization's purposes and goals, and that the mission of the organization is carried out.

Reasonable Compensation and Penalties for Excess Benefit Arrangements under IRS Code

In 1996, Congress enacted the Taxpayer Bill of Rights 2, which granted the IRS, for the first time, the authority to impose "intermediate sanctions" on certain individuals who use the assets of a Section 501(c)(3) tax-exempt organization, including tax-exempt hospitals, for improper personal gain. (For a detailed analysis of the intermediate sanctions rules, see "Excess Benefit and Reasonable Compensation: An Analysis of the Intermediate Sanctions Rules.") The intermediate sanctions rules expose to personal liability certain "insiders," called disqualified persons, and exempt organization managers. These rules provide specific guidance in the application of the general prohibitions on private benefit and private inurement by Section 501(c)(3) organizations.

If a hospital engages in a transaction or compensation arrangement for insiders that is not "reasonable" as measured by fair market value standards, penalties can be imposed on the individual receiving the compensation as well as on those who approved it. More specifically, disqualified persons initially are subject to a tax of 25 percent of the amount of the excess benefit, and are further subject to an additional tax of 200 percent of the excess benefit if the transaction or arrangement is not "corrected" within a designated time period. In addition, the managers of the exempt organization are subject to a tax of 10 percent of the excess benefit if they knowingly participated in an excess benefit transaction or arrangement, unless the participation was not willful and was due to reasonable cause.

What is an Excess Benefit Arrangement?

If compensation is provided by the hospital, directly or indirectly, to a disqualified person and the compensation exceeds the fair market value of the performance of services received by the hospital, an "excess benefit" has been awarded. This definition also includes any property transfer or transaction between a disqualified person and a tax-exempt organization.

Who is Covered by the Excess Benefit Rules?

As defined in IRS regulations, a disqualified person is any person who was in a position to exercise substantial influence over the affairs of the organization at any time during the five-year period ending on the date of the arrangement. Disqualified persons also include a member of the family of a person who was in a position to exercise such influence, and an entity controlled 35 percent or more by disqualified persons.

Persons Having Substantial Influence

A person is in a position to exercise substantial influence over an organization if that person has the powers or responsibilities, or holds the type of interests, described in one of the following categories:

- Presidents, chief executive officers or chief operating officers: An individual may serve in one of these capacities, regardless of title, if that person has or shares ultimate responsibility for implementing the

decisions of the governing body or supervising the management, administration or operation of the applicable organization.

- Treasurers and chief financial officers: An individual may serve in one of these capacities, regardless of title, if that individual has or shares ultimate responsibility for managing the organization's financial assets.
- Individuals serving on the governing body who are entitled to vote.
- Persons with a material financial interest in a provider-sponsored organization if a hospital that participates in the provider-sponsored organization is an applicable tax-exempt organization.

Facts Suggesting Substantial Influence

If a person does not fall within the above-described categories, the determination of whether he or she is a disqualified person depends on all of the facts and circumstances, such as whether:

- the person's compensation is primarily based on revenues derived from activities of the organization that the person controls;
- the person has or shares authority to control or determine a substantial portion of the organization's capital expenditures, operating budget or compensation for employees;
- the person has managerial control over a discrete segment of the applicable exempt organization and the segment represents a substantial portion of an applicable exempt organization's activities, assets, income or expenses (e.g., the head of a hospital's cardiology department is a disqualified person where that particular department is a principal source of patients and revenue for the hospital);
- the person is a substantial contributor to the organization;
- the person owns a controlling interest (measured by vote or value) in a corporation, partnership or a trust that is a disqualified person; or
- the "person" is a non-stock organization controlled, directly or indirectly, by one or more disqualified persons.

What is Reasonable Compensation?

Compensation paid to a disqualified person will not be regarded as an excess benefit if the total compensation paid is reasonable. Reasonable compensation is defined as "an amount that would ordinarily be paid for like services by like enterprises, whether taxable or tax-exempt, under like circumstances." Compensation includes but is not limited to:

- all forms of cash and non-cash compensation, including salary, fees, bonuses and severance payments paid;
- all forms of deferred and non-cash compensation that is earned and vested;
- the amount of premiums paid for liability or any other insurance coverage; and
- all other benefits such as medical, dental, life and disability insurance.

Initial Contract Exception

The intermediate sanctions rules are not applied to any fixed payment made pursuant to a binding written contract between the hospital and a party who was not a disqualified person immediately prior to entering into the contract (e.g., a newly-hired chief executive officer of an organization).

Timing Rules for Determining Reasonableness of Compensation Paid to Disqualified Persons

Reasonableness is determined with respect to any fixed payment at the time the parties enter into the contract. For non-fixed payments, rea-

sonableness of compensation is based on all the facts and circumstances, up to and including circumstances as of the date of the non-fixed payment. These general timing rules apply to property subject to a substantial risk of forfeiture. Therefore, if the property is subject to a substantial risk of forfeiture and satisfies the definition of fixed payment, reasonableness is determined at the time the parties enter into the contract providing for the transfer of the property. However, if the property is not a fixed payment, then reasonableness is determined based on all the facts and circumstances, up to and including circumstances as of the date of payment.

Revenue-sharing Arrangements

The regulations do not provide any guidance on the controversial topic of "revenue-sharing" transactions or arrangements in which compensation is calculated by reference to the exempt organization's revenues. Such arrangements are often entered into between physicians and hospitals. The IRS continues to reserve the revenue-sharing arena for possible future consideration in additional regulations. In the meantime, revenue-sharing arrangements will continue to be subject to the general rules governing excess benefit transactions.

Physician Compensation

Hospital recruitment of physicians is an area to which the IRS has paid particular attention with respect to unreasonable compensation or other forms of inurement. Guidance in this area, however, is relatively sparse. For example, in a 1973 revenue ruling, the IRS held that in certain circumstances, any personal benefit derived by a physician will not detract from the public purpose of a health care organization, lessen the public benefit flowing from its activities, or be considered to be a prohibited private benefit.[3] In this particular situation, the community was totally lacking in local medical services and the organization found that the lack of adequate facilities was a significant factor in the inability of the community to induce a doctor to locate in the community. The organization entered into an arrangement to induce a physician to locate to the community by erecting a medical services building and offering reasonable rent, which was negotiated in good faith, although it was less than what would be necessary to provide a normal return on the investment in the facility.

In 1997 the IRS provided five scenarios illustrating how hospitals can avoid violating the requirements for exemption under section 501(c)(3) when they provide incentives to recruit physicians to join their medical staff or to provide medical services in the community.[4] Four of the five scenarios satisfied the requirements for exemption. The hospitals in each situation demonstrated a specific need for certain doctors or medical care in their service areas and engaged in activities bearing a reasonable relationship to promoting and protecting the health of the community. The hospital in the scenario that did not satisfy the IRS requirements had engaged in physician recruiting practices that were in violation of anti-fraud regulations.

In 2002, the IRS released an information letter detailing the factors that will be considered in determining whether incentive-based compensation arrangements result in private inurement or impermissible private benefit.[5] These factors, listed below, emphasize that, in addition to being reasonable, compensation arrangements must also include features that further protect against private inurement and impermissible private benefit:

- Was the compensation arrangement established by an independent board of directors or an independent compensation committee?
- Does the compensation arrangement with the physician result in total compensation that is reasonable?

- Is there an arm's length relationship between the health care organization and the physician, or does the physician participate impermissibly in the management or control of the organization in a manner that affects the compensation arrangement?
- Does the compensation arrangement include a ceiling or reasonable maximum on the amount a physician may earn to protect against projection errors or substantial windfall benefits?
- Does the compensation arrangement have the potential for reducing the charitable services or benefits that the organization would otherwise provide?
- Does the compensation arrangement take into account data that measures quality of care and patient satisfaction?
- If the amount a physician earns under the compensation arrangement depends on net revenues, does the arrangement accomplish the organization's charitable purposes, such as keeping actual expenses within budgeted amounts, where expenses determine the amounts charged for charitable services?
- Does the compensation arrangement transform the principal activity of the organization into a joint venture between it and a physician or group of physicians?
- Is the compensation arrangement merely a device to distribute all or a portion of the organization's profits to persons who are in control of the organization?
- Does the compensation arrangement serve a real and discernable business purpose of the exempt organization, such as to achieve maximum efficiency and economy in operations, that is independent of any purpose to operate the organization for the impermissible direct or indirect benefit of the physicians?
- Does the compensation arrangement result in no abuse or unwarranted benefits because, for example, prices and operating costs compare favorably with those of similar organizations?
- Does the compensation arrangement reward the physician based on services the physician actually performs, or is it based on performance in an area where the physician performs no significant functions?

How Can a "Presumption of Reasonableness"[6] be Established?

Payments under a compensation arrangement, a property transfer or any other benefit or privilege between a hospital and a disqualified person shall be presumed to be reasonable if the following three requirements are met:

- The compensation arrangement or terms of the property transfer are approved by the organization's governing body, or committee of the governing body, or party authorized by the governing body, and the decision-making body is composed entirely of individuals who do not have conflicts of interest with respect to the compensation arrangement or transaction.
- The governing body, or committee thereof, or party authorized by the governing body obtained and relied upon appropriate comparability data on total compensation before making its decision.
- The governing body, or committee thereof, or party authorized by the governing body adequately documented the basis for its determination concurrently with making that determination.

Once the presumption is established, the IRS may rebut the presumption with additional information showing that the compensation was not reasonable or that the transfer was not at fair market value. Failure to establish the

"presumption of reasonableness" does not create an inference that the transaction is an excess benefit transaction.

What is an Adequate Approval Process?

The governing body is the Board of Directors, trustees or equivalent controlling body of the tax-exempt organization. The Board may authorize a committee of the Board members to act on behalf of the Board to the extent permitted by state law. If the organization's controlling documents or state law requires Board approval of an arrangement or transaction, then committee approval will not be sufficient. The Board also may authorize other parties to act on its behalf in approving compensation arrangements or property transfers, provided it specifies procedures and such delegation is allowed under state law.

As required, decision-makers may not have a conflict of interest. A person will not have a conflict if he or she:

- is not the disqualified person, or anyone related to or benefiting from the compensation arrangement;
- is not in an employment relationship subject to the direction or control of any disqualified person participating in or benefiting from the compensation arrangement;
- is not receiving compensation or other payments subject to approval by any disqualified person participating in or benefiting from the compensation arrangement; and
- has no material financial interest affected by the compensation arrangement or transaction.

If a Board authorizes a compensation committee, it should establish a specific charter for the committee. The charter should reflect the required process for consideration and approval of compensation. (See "Sample Compensation Committee Charter.")

What is Appropriate Comparability Data?

In making a determination as to reasonableness of compensation or fair market value, the Board or committee must have obtained and relied upon appropriate data as to compensation comparability. Appropriate data includes compensation paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the availability of similar services in the geographic area of the applicable tax-exempt organization; current compensation surveys compiled by independent firms; actual written offers from similar institutions competing for the services of the disqualified person; and independent appraisals of the value of property that the applicable organization intends to purchase from, or sell or provide to the disqualified person.

What is Sufficient Documentation?

For a decision to be documented adequately, the written or electronic records of the Board or committee must specify:

- the terms of the compensation that was approved and the date it was approved;
- the members of the governing body or committee who were present during discussion of the arrangement that was approved and those who voted on it;
- the comparability data obtained and relied upon by the governing body or committee and how the data was obtained; and
- the actions taken with respect to the arrangement by anyone who is a member of the governing body or committee, but who had a conflict of interest with respect to the arrangement.

The requirement of concurrent documentation means that records must be prepared by the later of the next meeting of the Board or committee or sixty (60) days after the final Board or committee approval of a particular arrangement or property transfer. Such records must be reviewed and approved by the Board or committee as reasonable, accurate and complete within a reasonable time period thereafter.

When Can the "Presumption of Reasonableness" be Established?

The regulations state that a organization can establish a rebuttable presumption of reasonableness with respect to fixed payments (or calculated pursuant to a fixed formula) at the time the parties enter into the contract. Likewise, under a special rule, the presumption of reasonableness can be established for payments made pursuant to a deferred compensation arrangement such as a qualified pension, profit-sharing or stock bonus plan when the parties enter into the contract for services.

In contrast, for non-fixed payments, the presumption can only be established after discretion is exercised, the exact amount of the payment is determined and the three requirements for the rebuttable presumption are satisfied. The regulations do include a limited exception for non-fixed payments subject to a cap. Under this exception, the presumption of reasonableness can be established for non-fixed payments if:

- prior to approving the contract, the governing body obtains comparability data showing that a fixed payment up to a certain amount would be reasonable compensation;
- the maximum amount payable under the contract including fixed and non-fixed payments does not exceed the reasonable compensation amount; and
- the other requirements for establishing the presumption of reasonableness are satisfied.

Preparing for New Form 990 Reporting

In addition to compensation reporting for Board members, officers and the five highest-compensated employees, the new Form 990 requires the reporting of information on "key employees."

A "key employee" is an employee of the organization, other than an officer, director or trustee, who:

- receives reportable compensation from the organization and all related organizations exceeding $150,000 for the year (the "$150,000 Test");
- has responsibilities, powers or influence over the organization as a whole that is similar to those of officers, directors or trustees;
- manages a discrete segment or activity of the organization that represents 10 percent or more of the activities, assets, income or expenses of the organization, as compared to the organization as whole; or has or shares authority to control or determine 10 percent of more of the organization's capital expenditures, operating budget or compensation for employees (collectively, the "Responsibility Test"); and
- is one of the 20 employees (that satisfies the $150,000 and the Responsibility Test) with the highest reportable compensation from the organization and related organizations for the calendar year ending with or within the organization's tax year.

The Form 990 also requires reporting of compensation to former officers, key employees and trustees whose compensation meets certain thresholds. Reportable compensation includes compensation from the organization and related organizations and compensation from any unrelated entity if it provided services to the reporting organization.

Note:

To assure compliance with IRS standards of professional practice, Hogan & Hartson, L.L.P., discloses to you that any federal tax advice in this communication was not intended or written to be used, and cannot be used, for the purpose of avoiding federal tax penalties; and, if used to promote, market, or recommend any transaction, investment or matter, the advice was written to support the promotion or marketing of the transaction or matters addressed. Taxpayers should seek advice, based on their particular circumstances, from an independent tax advisor.

Special thanks to Deborah T. Ashford, Esq., of Hogan & Hartson, L.L.P., for her work in drafting this primer and the corresponding documents. Thanks also to David Bjork of Integrated Healthcare Strategies for his review of and comments on this primer.

Footnotes

[1] Daniel L. Kurtz, Safeguarding the Mission: The Duties and Liabilities of Officers and Directors on Nonprofit Organizations, C726 ALI-ABA 15, 30 n.31 (Apr. 9, 1992); Revised Model Nonprofit Corporation Act § 8.30, Official Comment § 3 ("While the application of the business judgment rule to directors of nonprofit corporations is not firmly established by the case law, its use is consistent with section 8.30.").

[2] Harvey J. Goldschmid, The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms, 23 J. Corp. L. 631, 648 n.19 (1998).

[3] Rev. Rul. 73-313.

[4] Rev. Rul. 97-21.

[5] IRS Info. 2002-0021.

[6] The applicable regulations refer to this concept as a "rebuttable presumption" of reasonableness; however, for clarity "presumption of reasonableness" is used throughout this discussion.[VII]As referenced in Code Section 414(q)(1)(B)(i). For 2007, this amount is $100,000.

References

Internal Revenue Service, Report on Exempt Organizations Executive Compensation Compliance Project – Parts I and II (March 2007), available at http://www.irs.gov/pub/irs-tege/exec._comp._final.pdf.

U.S. Government Accountability Office, Nonprofit Hospital Systems: Survey on Executive Compensation Policies and Practices, GAO-06-907R (June 30, 2006), available at http://www.gao.gov/new.items/d06907r.pdf.

Independent Sector Organization, Panel on the Nonprofit Sector: Strengthening Transparency, Governance, Accountability of Charitable Organizations, at 66 (June 2005), available at http://www.nonprofitpanel.org/Report/final/Panel_Final_Report.pdf.

People v. Grasso, No. 120, 2008 N.Y. LEXIS 1821 (N.Y. June 25, 2008), available at http://www.nycourts.gov/ctapps/decisions/jun08/120opn08.pdf.

Ins. Comm'r for Md. V. CareFirst, Inc., Md. Ins. Admin., MIA-2007-10-027 (July 14, 2008), available at http://www.mdinsurance.state.md.us/sa/documents/MIA-2007-10-027-CareFirstFinalOrderall07-08.pdf.

Internal Revenue Service, EO CPE Text, Reasonable Compensation (1993), available at http://www.irs.gov/pub/irs-tege/eotopici93.pdf.

Internal Revenue Service, EO CPE Text, Physician Incentive Compensation (2000), available at http://www.irs.gov/pub/irs-tege/eotopicc00.pdf.